

Message Text

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FM AMEMBASSY BONN

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INFO USMISSION OECD PARIS

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C O N F I D E N T I A L SECTION 01 OF 05 BONN 08375

DEPARTMENT PLEASE PASS TREASURY AND FEDERAL RESERVE

E.O. 11652: GDS

TAGS: EFIN, GW

SUBJECT: THE BUDGETARY CRUNCH

REF: BONN 02433

1. SUMMARY. THE GAP BETWEEN TAX REVENUES AND GOVERN-

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MENTAL EXPENDITURES IS PROJECTED BY THE EMBASSY AS

LEADING TO DEFICITS EQUAL TO OVER 3 PERCENT OF GNP IN BOTH 1975 AND 1976, OR DM 32 BILLION AND DM 35 BILLION, RESPECTIVELY. THIS IS AN UNPRECEDENTED MAGNITUDE OF FISCAL IMBALANCE IN GERMANY AND AS SUCH IS STIMULATING SOME SOUL-SEARCHING. BUSINESS CYCLE CONDITIONS RESTRICTING REVENUES AS WELL AS GROWING SOCIAL WELFARE OUTLAYS ARE THE PRINCIPAL CONTRIBUTING FACTORS. OPPOSITION SPOKESMEN MAY ALLEGE FISCALLY IRRESPONSIBLE GOVERNMENT POLICIES AS THE CAUSE. THE MOST OBVIOUS REMEDY MENTIONED IS A TAX INCREASE, BUT THE GOVERNMENT WOULD PREFER TO AVOID THIS UNPOPULAR STEP, NOT ONLY IN 1975 BUT ALSO IN ELECTION-YEAR 1976 FOR BOTH POLITICAL AND ECONOMIC REASONS. HOWEVER, MOST CONSIDER AN EVENTUAL TAX INCREASE INEVITABLE IN THE LONG-, IF NOT THE SHORT-RUN. END SUMMARY

2. TAX REVENUES THIS YEAR AND NEXT ARE PREDICTED TO BE CONSIDERABLY LOWER THAN EXPENDITURES, LEADING TO DEFICITS OF UNPRECEDENTED MAGNITUDES IN GERMANY. UNDERLYING THIS SITUATION ARE, FOR THIS YEAR, STAGNANT GNP GROWTH, AND IN 1976 A RESUMPTION OF GROWTH BUT OVER A LOW REAL BASE NO HIGHER THAN IT WAS IN 1973. TO ALL OF THIS MUST BE ADDED THE EFFECT OF A PERHAPS TOO COSTLY BUT POLITICALLY UNAVOIDABLE TAX REFORM PROGRAM. FURTHERMORE, GOVERNMENT EXPENDITURES ARE SOARING IN RESPONSE TO SOME COUNTERCYCLICAL SPENDING AND INCREASED TRANSFER PAYMENT STEMMING FROM HIGH UNEMPLOYMENT AND GROWING SOCIAL WELFARE OUTLAYS (WHICH HAVE INCREASED FROM AN AVERAGE 29 PERCENT OF THE BUDGET OVER THE PAST SIX YEARS TO 36 PERCENT IN 1975). THE DEBATE IS NOW BEGINNING WITHIN THE GOVERNMENT, THE POLITICAL PARTIES AND THE PRESS OVER THE POTENTIAL IMPACT OF THE RESULTANT BUDGETARY DEFICITS ON INFLATION RATES, CAPITAL MARKETS, POLITICAL FORTUNES, AND THE LONG-TERM ECONOMIC WELL-BEING OF THE NATION. HOW IS THE DEFICIT TO BE DEALT WITH? TAX INCREASES ARE FREQUENTLY CITED AS INEVITABLE, BUT THIS BRINGS PROBLEMS FOR AN ECONOMY THAT IS HAVING DIFFICULTY GETTING LAUNCHED INTO AN UPTURN AND FOR A GOVERNMENT FACING NATIONAL ELECTIONS. IT IS ANOTHER (ADDED TO RECESSION, INFLATION AND UNEMPLOYMENT) CONFIDENTIAL

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MAJOR ECONOMIC-POLICY TIGHTROPE FOR THE FRG TO WALK AND AS SUCH WE HERE ATTEMPT TO EXAMINE IT AND QUANTIFY ITS PARAMETERS, POINTING TO SOME POSSIBLE GOVERNMENTAL COURSES OF ACTION.

2. FEDERAL REVENUE: 1975 AND 1976 PROJECTIONS.

A. REVENUE AS A PERCENT OF GNP HAS BEEN TRENDING

DOWNWARD OVER THE PAST DECADE FROM A HIGH OF 13.71 PERCENT IN 1964 TO 12.33 PERCENT IN 1974. OUR PROJECTION ASSUMES THAT IT WILL REMAIN CONSTANT AT THE SAME LEVEL IN 1975 AND 1976 WITH THE EXCEPTION OF AN ADJUSTMENT MADE TO REFLECT THE TAX REFORM. WE ACCEPT THE GOVERNMENT ESTIMATE THAT THE THEORETICAL LOST REVENUE IN 1975 DUE TO THE TAX REFORM/CHILDREN'S ALLOWANCES PACKAGE IS DM 14.2 BILLION. SINCE THE FEDERAL SHARE OF TOTAL TAX REVENUE IS APPROXIMATELY 50 PERCENT, WE ASSUME THAT THE COST OF THE REFORM WILL BE BORNE BY THE FEDERAL GOVERNMENT IN THE SAME MEASURE, I.E., DM 7.1

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R 231612Z MAY 75

FM AMEMBASSY BONN

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BILLION (A VERY OPTIMISTIC ASSUMPTION SINCE THE LAENDER ARE INSISTING THAT THE FEDERAL GOVERNMENT CARRY A HEAVIER BURDEN). THIS AMOUNT EQUATES TO .67 PERCENT OF ANTICIPATED GNP IN 1975. THEREFORE, THE FEDERAL REVENUE SHARE OF GNP IS ASSUMED ON AN ADJUSTED BASIS TO BE 11.66 PERCENT (12.33-.67) FOR BOTH 1975 AND 1976.

B. NOMINAL GNP GROWTH IN 1975 IS FORECAST BY THE GERMAN ECONOMIC INSTITUTES TO BE 7.6 PERCENT, REFLECTING A 7 PERCENT DEFLATOR AND 0.6 PERCENT REAL GROWTH. WE
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ACCEPT THIS AS PART OF OUR ASSUMPTION BASE. WE PROJECT THAT IN 1976 REAL GNP GROWTH WILL BE 5 PERCENT AND THAT INFLATION WILL BE 6 PERCENT, FOR A NOMINAL GNP GROWTH OF 11 PERCENT. WHILE A 1976 GROWTH RATE OF THIS MAGNITUDE ALSO HAS BEEN THE WORKING ASSUMPTION OF FINANCE AND ECONOMIC MINISTRY EXPERTS, SOME GERMAN OFFICIALS, INCLUDING EXPERTS IN THE CHANCELLOR'S OFFICE, ARE NOW FORECASTING ONLY 3 TO POSSIBLY 4 PERCENT REAL GNP GROWTH FOR NEXT YEAR, AND NOMINAL GNP GROWTH OF 9 PERCENT. THIS IS INDICATED AS A LOW-SIDE ALTERNATIVE ASSUMPTION IN OUR PRESENTATION.

C. THE FOREGOING SET OF ASSUMPTIONS LEADS TO THE FOLLOWING FORECAST:

1975	1976
---	-----
(BILLION DM)	

A) NOMINAL GNP	1071	1178	1167
PERCENT GROWTH/PREVIOUS YEAR	(7.6)	(11)	(9)
B) FEDERAL REVENUE	145.9	137.4	136.1
(11.66 PERCENT OF A))			

3. FEDERAL BUDGETARY EXPENDITURES: 1974 AND 1976 PROJECTIONS.

A. THE GOVERNMENT FORECAST IN MARCH THAT ITS 1975 EXPENDITURES WOULD BE DM 155.1 BILLION. ACCORDING TO WHAT GOVERNMENT SOURCES NOW TELL THE EMBASSY, THIS WILL HAVE TO BE INCREASED BY ANOTHER DM 2 BILLION TO COVER ADDITIONAL SUBSIDIES TO COVER UNEMPLOYMENT BENEFIT PAYMENTS. THE PRESENT EMBASSY PROJECTION THEREFORE ASSUMES 1975 EXPENDITURES WILL REACH DM 157.1 BILLION.

B. FOR 1976 THERE ARE THREE ALTERNATIVE APPROACHES

TO FORECASTING EXPENDITURES:

L) THE GOVERNMENT FORECAST IN ITS FINANCE
PLAN PUBLISHED IN MID-1974, BEFORE THE UNEMPLOYMENT
PROBLEM AND THE INHERENT ADDITIONAL BUDGETARY OUTLAYS
LOOMED SO LARGE AND LIKELY, THAT 1976 TOTAL FEDERAL
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EXPENDITURES WOULD INCREASE 10.3 PERCENT OVER THE LEVEL
OF 1975.

2) THE MOST OPTIMISTIC 1976 EXPENDITURE
ASSUMPTION IS BASED ON THE IMPLEMENTATION OF A DEEP-
CUTTING SAVINGS OR ECONOMY PROGRAM BY THE GOVERNMENT.
THE MAXIMUM POSSIBILITY FOR THIS WOULD SEEM, ACCORDING
TO OUR CONTACTS IN BOTH THE FINANCE MINISTRY AND THE
CHANCELLOR'S OFFICE, TO PERMIT AN EXPENDITURE RISE OF
7-8 PERCENT. THIS WOULD AMOUNT TO DM 168.9 BILLION AS
COMPARED WITH THE ADMITTEDLY DATED AND OPTIMISTIC
FINANCE PLAN FORECAST OF DM 169.7 BILLION. IT WOULD
REPRESENT UP TO A 3-4 PERCENT REDUCTION IN REAL TERMS ON
1975 EXPENDITURES, WHICH IS A HIGHER REAL CUT THAN ANY
SUSTAINED IN RECENT GERMAN FISCAL HISTORY. IT WOULD
IMPLY NEAR-ZERO WAGE GAINS FOR FEDERAL EMPLOYEES, AND
SUBJECT THE BURGEONING SOCIAL WELFARE OUTLAYS TO THE
THREAT OF THE BUDGET CUTTER'S KNIFE AND TOUCH MANY OTHER
SENSITIVE ELEMENTS DIFFICULT TO TAMPER WITH IN AN
ELECTION YEAR.

3) ANOTHER, PERHAPS MORE REALISTIC, APPROACH
IS TO BUILD UPON THE 1975 EXPENDITURE BASE AS FOLLOWS:

ADDITIONAL COSTS DUE TO
FIXED COMMITMENTS OF
SOCIAL WELFARE PROGRAMS, DM 7.7 BILLION

ADDITIONAL COSTS FOR
INTEREST PAYMENTS DUE TO
HIGHER BORROWING THAN
PREVIOUSLY ANTICIPATED, 3.0

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R 231612Z MAY 75

FM AMEMBASSY BONN

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ADDITIONAL COSTS FOR
SALARIES (EQUATES TO
7 PERCENT WAGE HIKE,
INCLUDING PROMOTIONS), 1.9

DM 12.6 BILLION

THE SOCIAL PROGRAMS, INTEREST PAYMENTS AND FEDERAL
EMPLOYEE SALARIES AMOUNT TO ABOUT 54 PERCENT OF THE
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TOTAL BUDGET AND ARE MORE OR LESS FIXED AND NOT READILY
SUBJECT TO REDUCTION BELOW THE STIPULATED FIGURES,

ESPECIALLY IN AN ELECTION YEAR. THE REST OF THE BUDGET WOULD, HOWEVER, BE MORE VULNERABLE TO A CUTTING EXERCISE, BUT ONE WITH LIMITS. IN THIS CASE WE ASSUMED THAT THE LIMIT WOULD BE ZERO REAL GROWTH. THIS WOULD MEAN 6.5 PERCENT NOMINAL GROWTH (ONE PERCENTAGE POINT LESS THAN THE GOVERNMENT CONSUMPTION DEFLATOR FORECAST FOR 1975 BY THE INSTITUTES) FOR 46 PERCENT OF GOVERNMENT EXPENDITURES IN 1976. THE NET NOMINAL GROWTH ON THIS ACCOUNT WOULD AMOUNT TO DM 4.7 BILLION. ADDING THE TWO INCREMENTS OF DM 4.7 BILLION AND DM 12.6 TO THE 1975 BASE OF DM 157.1 EQUALS A PROJECTED 1976 FEDERAL GOVERNMENT EXPENDITURE OF DM 174.4 BILLION. COINCIDENTALLY THIS AMOUNT HAS THE SAME RATE OF EXPENDITURE INCREASE (11 PERCENT) AS THAT ASSUMED FOR GNP.

TABLE A

	1975 1/	1976			
	-----	-----			
		11 PERCENT NOMINAL GNP GROWTH ASSUMPTIONS PER PARAGRAPH 3			
	-----	-----			
	(B 1)	(B 2)	(B 3)		
	-----	-----	-----		
REVENUE 2/	124.9	137.4	137.4	137.4	
EXPENDITURES	157.1	173.2	168.9	174.4	
(PERCENT GROWTH OVER PREVIOUS YEAR)	(17.9)	(10.3)	(7.5)	(11.0)	
DEFICIT	32.2	35.8	31.5	37.0	

1/ 7.6 PERCENT NOMINAL GNP GROWTH ASSUMPTION.

2/ TAX AND ADMINISTRATIVE REVENUES.

TABLE B
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1976

9 PERCENT NOMINAL GNP GROWTH ASSUMPTIONS PER PARAGRAPH 3

(B 1) (B 2) (B 3)

REVENUE L/	136.1	136.1	136.1
EXPENDITURES	173.2	168.9	174.4

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R 231638Z MAY 75
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(PERCENT GROWTH
OVER PREVIOUS
YEAR (10.3) (7.5) (11.0)

DEFICIT 37.1 32.8 38.3

1/ TAX AND ADMINISTRATIVE REVENUES.

5. AS MAY BE SEEN IN TABLE A ABOVE, THE DEFICIT
PROJECTED BY THE EMBASSY FOR THE FEDERAL GOVERNMENT FOR
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THE YEAR 1975 AMOUNTS TO DM 32.2 BILLION. THIS ESTIMATE
IS BASED ON WHAT MUST BE CONSIDERED A CONSERVATIVE SET
OF ASSUMPTIONS. A RECENT CONVERSATION WITH A
CHANCELLERY OFFICIAL INDICATED THAT THEIR CURRENT
PROJECTIONS POINT TOWARDS A DEFICIT OF ABOUT DM 31
BILLION, OR NOT FAR FROM THE EMBASSY FORECASTED AMOUNT.
BY COMPARISON, THE GOVERNMENT'S LAST PUBLIC ESTIMATE,
MADE IN MARCH, INDICATED A 1975 DEFICIT OF DM 25.7
BILLION. ANOTHER REVENUE AND RESULTANT DEFICIT ESTIMATE
IS EXPECTED TO BE MADE PUBLIC BY THE GOVERNMENT IN
JUNE,
WHICH WILL UNDOUBTEDLY COME CLOSER TO THE EMBASSY AND
CHANCELLERY ESTIMATES JUST MENTIONED. THE GOVERNMENT
INDICATES IT HAS ABSOLUTELY NO INTENTION TO CLOSE THE
GAP BETWEEN 1975 REVENUES AND EXPENDITURES VIA AN
INCREASE IN TAXES SINCE BUSINESS CYCLE CONDITIONS
JUSTIFY THE RUNNING OF A HIGH DEFICIT.

6. TABLES A AND B DEMONSTRATE A RANGE OF POSSIBILITIES
FOR THE 1976 DEFICIT AS LYING BETWEEN DM 31.5 TO 38.3
BILLION. AS MAY BE SEEN THERE ARE NUMEROUS ALTERNATIVE
POSSIBILITIES, EACH WITH COGENT AND LOGICAL SUPPORTING
ARGUMENTS AND IT IS DIFFICULT THIS FAR IN ADVANCE TO
PICK ANY ONE OF THEM AS REPRESENTING THE SINGLE MOST
RATIONAL AND LIKELY OUTCOME. OUR CONVERSATIONS WITH THE
GERMAN OFFICIALS INVOLVED WITH THIS PROBLEM SUGGEST TO
US THAT THEY ARE NO MORE SURE THAN WE OF WHAT THE
MAGNITUDE OF THE 1976 BUDGETARY DEFICIT WILL BE. IF A
SINGLE NUMBER IS TO BE CITED, WE WOULD BE INCLINED TO
AVERAGE THE HIGH AND LOW FIGURES IN TABLES A AND B AND
COME UP WITH A GUESTIMATE OF DM 35 BILLION, IF NO OTHER
CHANGE IN THE EQUATION TAKES PLACE -- AN IMPORTANT
QUALIFICATION.

7. THE MOST OBVIOUS REMEDY TO COUNTER THE PROJECTED
HIGH 1976 DEFICIT, OF COURSE, WOULD BE AN INCREASE IN
TAXES. THE MOST FREQUENTLY MENTIONED ROUTE IS TO
INCREASE THE VALUE-ADDED TAX BY 2 PERCENTAGE POINTS FROM
11 TO 13 PERCENT. THIS ACTION WOULD PROVIDE THE FEDERAL
GOVERNMENT WITH ABOUT DM 6-7 BILLION IN ADDITIONAL
REVENUE. HOWEVER, OUR GOVERNMENT CONTACTS ALL TELL US
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THAT THEY ARE NOT YET THINKING IN TERMS OF RAISING TAXES
IN 1976. THEY ARE FAR FROM SURE HOW STRONG THE RECOVERY
IN FACT WILL BE BY THE BEGINNING OF 1976 AND FEAR THAT A
TAX INCREASE AT THAT TIME MAY NIP IT IN THE BUD..IN
ADDITION 1976 WILL BE A NATIONAL ELECTION YEAR. A TURN-
OVER TAX INCREASE WILL BE IMMEDIATELY REFLECTED IN
CONSUMER PRICES AND THE GERMAN VOTER IS PROBABLY ONE OF
THE MOST PRICE SENSITIVE IN THE WORLD. HOWEVER, THE
GERMAN PUBLIC IS ALSO SENSITIVE TO WHAT MIGHT BE
PERCEIVED, RIGHTFULLY OR WRONGFULLY, AS FISCALLY
IRRESPONSIBLE MANAGEMENT OF THE GOVERNMENT FINANCES --
A POINT OF VULNERABILITY NOT LIKELY TO BE OVERLOOKED BY

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THE POLITICAL OPPOSITION. A FEDERAL GOVERNMENT BUDGET DEFICIT OF DM 35 BILLION WOULD EQUAL ABOUT 3 PERCENT OF THE GNP, APPROXIMATELY THE SAME PROPORTION AS IS FORECAST FOR 1975. IN POSTWAR GERMAN ECONOMIC HISTORY IT IS ONLY IN THE RECESSION YEAR OF 1967, WHEN THE DEFICIT AMOUNTED TO 1 1/2 PERCENT OF GNP, THAT THE DEFICIT HAS EXCEEDED THE RATIO OF 1 PERCENT. INFLATIONARY PRESSURES AND CAPITAL MARKET CROWDING-OUT PROBLEMS WOULD UNDOUBTEDLY ALSO HAVE TO BE ADDED TO THE POLITICAL DIFFICULTIES PRESENTED BY THIS FISCAL CRUNCH. THE
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CURRENT GOVERNMENT STRATEGY, WHILE LEAVING OPEN A DECISION LATER ON IN THE YEAR ON POSSIBLE TAX INCREASES, IS TO CONCENTRATE ON DEMONSTRATING FISCAL RESPONSIBILITY BY A RIGOROUS 1976 BUDGET CUTTING EXERCISE. THE GOVERNMENT CLEARLY HOPES TO AVOID A TAX INCREASE IN 1976, BUT OUR CHANCELLERY CONTACT TELLS US THAT IN 1977 FOLLOWING THE ELECTIONS, A TAX INCREASE WOULD BE ABSOLUTELY INEVITABLE AND THIS WOULD HAVE TO BE UNDERTAKEN SIMULTANEOUSLY WITH A REALLY PROFOUND BUDGET AUSTERITY POLICY.

8. COMMENT. IRONICALLY, A RESUMPTION OF STRONGER ECONOMIC GROWTH IN 1976 WOULD NOT NECESSARILY SOLVE ALL PROBLEMS. SUCH GROWTH MIGHT REDUCE THE PROJECTED DEFICIT BY SOME BILLIONS, BUT THE DEFICIT NEVERTHELESS WOULD REMAIN OF A MAGNITUDE CLEARLY INAPPROPRIATE -- AND DANGEROUS FOR PRICE STABILITY -- UNDER CONDITIONS OF HIGH GROWTH. THE GOVERNMENT WOULD THEN BE FACED WITH THE ELECTION YEAR DILEMMA OF A TAX INCREASE OR RENEWED INFLATION. ON THE OTHER HAND, A SLUGGISH RECOVERY AND THE RESULTANT HIGHER DEFICIT (UP TO DM 38 BILLION BY OUR CALCULATIONS) MIGHT BE SUCCESSFULLY DEFENDED AS A NECESSARY ASPECT OF BUSINESS CYCLE POLICY AND MAKE IT POSSIBLE TO POSTPONE TAX INCREASE UNTIL AFTER THE 1976 ELECTION.
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Message Attributes

Automatic Decaptioning: X
Capture Date: 01 JAN 1994
Channel Indicators: n/a
Current Classification: UNCLASSIFIED
Concepts: BUDGET DATA, BUDGET ESTIMATES, REVENUE DATA, GOVERNMENT EXPENDITURES
Control Number: n/a
Copy: SINGLE
Draft Date: 23 MAY 1975
Decaption Date: 01 JAN 1960
Decaption Note:
Disposition Action: RELEASED
Disposition Approved on Date:
Disposition Authority: ElyME
Disposition Case Number: n/a
Disposition Comment: 25 YEAR REVIEW
Disposition Date: 28 MAY 2004
Disposition Event:
Disposition History: n/a
Disposition Reason:
Disposition Remarks:
Document Number: 1975BONN08375
Document Source: CORE
Document Unique ID: 00
Drafter: n/a
Enclosure: n/a
Executive Order: GS
Errors: N/A
Film Number: D750182-0175
From: BONN
Handling Restrictions: n/a
Image Path:
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Legacy Key: link1975/newtext/t19750520/aaaaartz.tel
Line Count: 598
Locator: TEXT ON-LINE, ON MICROFILM
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Original Classification: CONFIDENTIAL
Original Handling Restrictions: n/a
Original Previous Classification: n/a
Original Previous Handling Restrictions: n/a
Page Count: 11
Previous Channel Indicators: n/a
Previous Classification: CONFIDENTIAL
Previous Handling Restrictions: n/a
Reference: 75 BONN 02433
Review Action: RELEASED, APPROVED
Review Authority: ElyME
Review Comment: n/a
Review Content Flags:
Review Date: 11 APR 2003
Review Event:
Review Exemptions: n/a
Review History: RELEASED <11 APR 2003 by Izenbel0>; APPROVED <03 OCT 2003 by ElyME>
Review Markings:

Margaret P. Grafeld
Declassified/Released
US Department of State
EO Systematic Review
05 JUL 2006

Review Media Identifier:
Review Referrals: n/a
Review Release Date: n/a
Review Release Event: n/a
Review Transfer Date:
Review Withdrawn Fields: n/a
Secure: OPEN
Status: NATIVE
Subject: THE BUDGETARY CRUNCH
TAGS: EFIN, GE
To: STATE
Type: TE
Markings: Margaret P. Grafeld Declassified/Released US Department of State EO Systematic Review 05 JUL 2006